Plowing through the Facts: Farming Taxation

An Honors Thesis (HONR 499)

by

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Abstract and Acknowledgements

Abstract

This honors looks into some farming taxation solutions for small to medium sized Midwest farms. Information includes income, expenses, gains and losses, depreciation, self-employment taxes, basis of assets, and gifting.

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Definition of a Farm

The IRS defines a farm as a business if someone cultivates, operates, or manages a farm for profit, either as an owner or a tenant. This profit can be earned from a farm that includes, "livestock, dairy, poultry, fish, fruit, and truck farms, plantations, ranches, ranges, and orchards" (Internal Revenue Service, Publication 225). This definition will be important to farming taxation, as this will be the basis for understanding and applying issues presented in this paper. There are many specific issues related to farming taxation, which this paper tries to better explain.

Tax Records

Farmers should keep accurate records of all accounting related items. This includes but is not limited to wages, sales, and expenses. While not all of this information will be used when preparing a farmer's tax return, this information is still important for operating a successful farm and can help improve and make decisions for the farm. Additionally, any amounts reported on a tax return must have documents to support those amounts. This will be most important if and when an audit would occur.

If an audit were to occur, it is important to still have the applicable documents to support tax items. Support documents for tax returns must be kept for the latter of three years or within two years of the date of the tax payment. However, there are specific records which should be kept longer. For example, any information relating to employment taxes should be kept for at least four years after the latter of when the employment taxes were due or paid. Records of specific assets should be kept for the period of limitations after which the asset has been disposed of. Generally, this means that records need to kept while owning the assets and for at least three years after the disposal of the asset. Records of assets are required to be kept longer due to calculating depreciations, amortizations, and depletion deductions (Internal Revenue Service, Publication 225).

Accounting Methods

An accounting method refers to the method farmers use to account for income and expenses on the tax return. Each method has a different set of rules that must be used when accounting for income and expenses. In short, these rules will identify both how and when income and expenses should and can be reported. The two most common accounting methods are the cash method and the accrual method. Most farmers tend to use the cash method, simply because it tends to be the easier method to understand. Certain farm partnerships and corporations are forced use the accrual method though. Corporations, other than family corporations, which have gross receipts of more than $1,000,000 for any tax year beginning after 1975, family corporations that have gross receipts of more than $25,000,000 for any tax year beginning after 1985, partnerships with a corporation as a partner, and tax shelters must use the accrual method of accounting. These rules do not apply for S corporations though.

Under the cash method, income is earned when it is actually or constructively received. Constructively received refers to having the amount of money made available to the farmer. For example, once someone pays the farmer a check, then the farmer has received the money under the cash method (Internal Revenue Service, Publication 225). If the farmer, receiving the money in December 2012, were to wait to cash the check until the following year, January 2013, the farmer is still obligated to report the income in 2012, as that was the time that the income was constructively received. Expenses are very similar under the cash method, as expenses can be deducted in the year that the expense is paid. Prepaid expenses that are paid for liabilities beyond the current tax year are only deductible for the current tax year's expenses. The remaining expenses are deferred until the tax year that the expense occurs (Internal Revenue Service, Publication 225).

Under the accrual method, income is recorded when the "all-events test" has been met. The all events test simply refers to when, "all events that fix [the farmer's] right to receive the income have occurred and [the farmer] can determine the amount with reasonable accuracy." Thus, income should be recorded as income on the earliest of the following dates: (1) Receive payment (2) Income is due to the farmer (3) Earn the income (4) Title passes. Expenses can be recorded under the accrual method when the "all events test" has been met and economic performance has occurred (Internal Revenue Service, Publication 225). To better explain economic performance, suppose a farmer pays for a service in 2012, but the service does not occur until 2013. Under the accrual method, the expense cannot be recorded until 2013 because that is when economic performance occurred.

Another popular farming method is the crop method, which allows a farmer to deduct all expenses of producing crops in the year that crops are actually produced. There are other special methods of accounting, which will be explained in more detail later. The IRS allows for any combination of methods as long as the same method of recognizing income is used to deduct expenses as well. If a farmer would ever like to change the current method, he or she must first receive approval from the IRS before doing so.

Reporting Farm Income

Most income earned from farming related activities will be reported on the 1040 form, Schedule F, Profit or Loss from Farming. This form helps farmers determine their net profit or loss for the year. Income reported on this form includes income from, "cultivating, operating, or managing a farm for gain or profit, either as a tenant or owner." This form is used for farmers who make a profit from grain, dairy, or other livestock sales. Some sales of dairy or livestock may result in a capital gain or loss, depending on the situation. If a farm asset is not held primarily for resale, which would be the case for dairy cows, then the income earned as a result of a sale will end up being reported on Form 4797, Sales of Business Property, instead of Schedule F (Internal Revenue Service, Publication 225).

Nowadays many farmers purchase crop insurance annually. Any income received as a result on damaged crops should be reported on Schedule F as farm income. The income should be reported in the year that the farmer receives the payment. However, it is possible to elect to postpone reporting the income until the following year, if all of the following conditions are met: (1) The farmer must be using the cash method of accounting, as opposed to the accrual method. (2) The crop insurance proceeds must be received in the same year that the crops were damaged. (3) The farmer must be able to show that he or she would have included income for the crops in any tax year following. If these conditions are met, then the farmer should report the income on Schedule F, line 6a, but not include the amount on line 6b. There is a box to check on line 8c, indicating that the income will be reported in a future tax year. Then, the farmer must attach a statement detailing the election as well stating how the farmer has met the requirements of the election (Internal Revenue Service, Publication 225).

Some farmers may be part of a farm cooperative, and, as a result, receive income from that partnership as a result of patronage dividends. If this is the case, the farmer will receive a

1099-PATR in the applicable tax year. This income should be reported on Schedule F, lines 3a and 3b. It is possible for the 1099-PATR to also show an alternative minimum tax adjustment, which, if the case, needs to be included on Form 6251, Alternative Minimum Tax-Individuals.

Some other income items to include are that of customer hire, which is when a farmer receives income for custom or contract work, and should be reported on line 7b of Schedule F. Customer hire income includes when a farmer earns money for the use of his or her machinery. Another type of income could be from payment for a right-of-way. If the right-of-way affects the basis of a farmer's property, then the gain or loss should be reported on Form 4797. However, if the right-of-way does not affect the farmer's basis of the land, then the gain or loss is reported on line 8b of Schedule F.

Since income varies greatly with farmers, farmers have the option of averaging their income from the past three years. Farmers would tend to do this if the current year's income is high, as compared to the last three years. By averaging their income, farmers are able to pay fewer taxes when income is abnormally high one year. In order to average income, Schedule J must be completed. This opportunity is only available to individuals, partners of a partnership, and shareholders of a corporation (Internal Revenue Service, Publication 225). Thus, corporations, partnerships, S corporations, estates, and trust do not have this opportunity.

Reporting Farm Expenses

The general rule when deducting farm expenses is that the expense must be deducted in the year that is has occurred. The expenses must be considered "ordinary and necessary" in order to allow a deduction. However, there are some special rules that can limit or disallow certain expenses for a farm. In general though, most expenses will be deductible on the Schedule F.

Some expenses such as gasoline, oil, fuel, water, electric, and rent, may be used for both personal expenses as well as farm related expenses. When this is the case, the personal portion of those expenses is not deductible, but the expenses that are directly related to the operation of the farm are considered deductible. Although it is not always easy to determine the allocation between business and non-business activity, as long as a reasonable allocation is made between the business and non-business expense, then the business expense can be deducted on Schedule F (Internal Revenue Service, Publication 225).

One issue that may arise when deducting farm expenses, are how to account for prepaid expenses on Schedule F. Prepaid expenses may be deducted in the year occurred, but may be limited to 50% of other deductible farm expenses for the year. This rule does not apply if one of the following conditions is met. (1) Prepaid farm supplies expense is greater than 50% of other deductible expenses due to a change is operations cause by abnormal circumstances (2) Total prepaid expenses for the last three tax years is less than 50% of the other deductible farm expenses (Internal Revenue Service, Publication 225).

Labor expenses should be included as a farm expense on Schedule F. Both non-related and related individuals can be included as employees as long as a clear employer-employee relationship exists. This means that wages to children and spouses of farmers can be deducted as farm related expenses. Even if the wages to a child are spent on necessities, such as clothing, wages can still be deducted (Internal Revenue Service, Publication 225).

Another expense that can be deducted is farm related expenses from repairs. If the repair is actually more of an overhaul of depreciable property rather than simply a repair, the expense will actually be a capital expenditure (Internal Revenue Service, Publication 225). For example, if a farmer repairs a few shingles on a barn roof, the repair would be an expense on Schedule F. However, if the farmer replaces the entire barn roof, thus increasing the life of the barn, the expense must be reported as a capital expenditure and the life and depreciable basis of the barn must be adjusted.

When running a farm, many times a farm related vehicle is used. Like the expenses above, only the appropriate percentage of the expenses directly related to farm activity are deductible. Instead of using the actual costs of gasoline, repairs, oil, insurance, and depreciation, a standard mileage rate of 55.5 cents per mile can be used. The rule cannot be used if there are five or more vehicles used by a farm operation at one time. Travel expenses, outside of the items listed, such as meals and lodging are 50% deductible only if the business trip is overnight and requires some form of lodging (Internal Revenue Service, Publication 225).

Some farmers may be able to take a Domestic Production Activities Deduction, more commonly referred to as DPAD. In order for a farmer to be eligible for this deduction, the farmer must have employee wages or receive a DPAD from a flow through entity. If the former, then the farmer should be eligible to deduct 9% of income, up to 50% of W2 wages, which would give an incentive to have some form of an employee, even if it is a spouse or dependent. If the farmer receives a DPAD deduction from a flow through entity, then the farmer should be eligible for the amount listed from the flow through entity (Neiffer).

A few other common farm related expenses include interest, breeding fees, and rent, all of which are deductible in the applicable tax year. If a farmer rents a farm that includes a house, the fair value of the rental amount on the home is not deductible as a farm related expense (Internal Revenue Service, Publication 225).

Basis of Assets

When calculating gains, losses, depreciation, depletion, and amortization for tax purpose, the basis of the item needs to be known. The basis of the item refers to the amount of a farmer's current investment in that item for tax purposes. A farmer's basis in the item will be adjusted according to specific events. For example, if a farmer makes improvements to property, the basis of the property will increase. On the other hand, depreciation, deductions, and credits can reduce a farmer's basis in an item. If an item is used for both personal and business use, only the amount allocated towards the business can be depreciated.

The basis of property usually starts out as the cost of the product. The cost includes the actual amount paid in cash plus sales tax, freight, installation, and testing. However, basis of property does not include interest payments on a loan for the property. There are some exceptions to these rules though for real property, which refers to real estate. Real estate taxes are treated as part of a farmer's basis in the property. Additionally, settlement costs and closing costs are added to the basis. However, fees and costs associated with obtaining a loan for the property are not included in the basis. Section 179 deductions should be subtracted from the basis of the property, if that election is made (Internal Revenue Service, Publication 225).

Farms and farmland often end up being gifts or inherited property. When one of these events occurs, it is important that the basis of the land is calculated correctly. When receiving property as a gift, if the fair market value of the property is equal to or greater than the donor's adjusted basis, then the receiver's basis is the donor's adjusted basis in the property. Any gift tax paid should be added to the receiver's basis in the property, multiplied by the following fraction:

$$\frac{\text{Net increase in value of the gift}}{\text{Amount of the gift}}$$

The net increase in the value of the gift is the fair market value of the gift minus the donor's adjusted basis. The amount of the gift is the value for gift tax purposes. For example, supposed a farmer receives property that has a fair market value of $40,000 and the adjusted basis is $15,000. Thus, since gifts are allowed up to $13,000, only $27,000 of this amount would be eligible for gift tax. If $5,500 was paid for gift tax, then the basis would be calculated as follows:

Fair market value	$40,000
Less: Adjusted basis	$15,000
Net increase in value	$25,000
Gift tax paid	$5,500
Multiplied by ($25,000/$27,000)	x .93
Gift tax due to net increase in value	$5,115
Add: Adjusted basis property from donor	$15,000
Receiver's basis in the property	$20,115

On the other hand, the fair market value of the property may be less than the donor's adjusted basis. If the receiver sells the property for a gain after receiving the property, then the receiver should use the donor's adjusted basis in the gift as his or her basis when calculating the gain. However, if the receiver sells the property for a loss after receiving it, then the receiver should use the fair market value of the property as his or her basis in the property (Internal Revenue Service, Publication 225).

Depreciation

With farmers having a large amount of assets for farm related uses, majority of these assets can offer a depreciation deduction on a farmer's tax return. Each asset a farmer has is given a useful life. The cost of the asset can then be depreciated over its useful life using different methods. In 2012, the maximum amount of deprecation allowed to be deducted for property place in service in the tax year is $139,000. However, if the cost of the amount of property placed in service in the tax year exceeds $560,000, then an excess amount reduces the amount of depreciation able to be deducted. For example, if a farmer places $575,000 of property into service in 2012, then the maximum amount of depreciation deduction the farmer can deduct from the property placed in service would only be $124,000 (Internal Revenue Service, Publication 225).

Most tangible property can be depreciated, with the exception of land. In order to be depreciable, the property must meet the following requirements: (1) The farmer must own the property (2) The property must be used in that farmer's business (3) The property must have a determinable life (4) The useful life of the property must extend well past the year placed in service. In requirement (1), it is okay if the farmer is still paying on the debt for the property. However, if the farmer is leasing the property, then he or she may not depreciate the property.

Depreciating property first begins when the property is either placed in service or when it is ready and available for use. For example, if a farmer purchases a planter in the winter, the farmer will likely not use the planter until the spring. However, since the planter is ready and available for use, depreciation begins when the planter is delivered to the farmer's farm. Depreciation property ends when the cost has been fully recovered or when the farmer retires the product from use, whichever happens first. Retiring the product means that it is no longer readily and available for use. Thus, if a piece of machinery is sitting idle, but is still ready and available for use, then the machinery is not retired from use.

In order to depreciate property, farmers must use the depreciation method known as MACRS or Modified Accelerated Cost Recovery System. There are some instances where MACRS is not allowed though. Property placed in service before 1987, intangible property, and property elected to exclude from MACRS deprecation should not follow this method. Depreciated property should be completed on Form 4562, Depreciation and Amortization.

Current year section 179 deductions as well as section 179 carryovers should be included on this form.

Instead of recovering the cost of the asset using a regular depreciation method, a section 179 expense deduction can be taken as an alternative. In order to qualify for this deduction, property must be eligible, acquired for business use, and must have been acquired by purchase. In order to qualify as eligible property, the property must be tangible personal property, a single purpose agricultural structure, or a grain bin. Additionally, the property must be acquired by purchase. This means that any property acquired from a related party would not be eligible for the section 179 deduction.

The cost of property that is purchased using a trade-in of other property must be reduced by the amount of the trade-in. Thus, if a farmer purchases property for $20,000, but trades in a piece of equipment for $8,000, the remaining balance is $12,000, and the farmer must use the $12,000 as the cost of the property. Any carryover of disallowed deduction can be carried over to future tax returns for an unlimited number of years.

As already stated, in order to take the depreciation deduction, the percentage use of the property from farming activities must be great than 50% of the total use. If, for some reason, the percentage of business use from farming falls to 50% or less during the recovery period of the property, then that farmer must recapture a portion of that section 179 deduction. The amount calculated to be recaptured must then be included as ordinary income in that tax year. For example, suppose, in 2010, a farmer elects a section 179 deduction of $5,000. The allowable depreciation in 2010 and 2011 was $1,250 and $1,875 respectively. In 2010 this amount would have been $1,250 multiplied by the new use of property of 40%, or $500. These three amounts subtracted from $5,000, show that the 2012 recapture amount would be $1,375 (Internal Revenue Service, Publication 544).

When determining the depreciable amount for property, there are two main methods of MACRS to choose from. These two methods are the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). The general rule is that farmers should use the GDS system, unless property is specifically required to use ADS. Some property that must use the ADS system include: (1) Listed property used 50% or less in a qualified (2) Tax-exempt property (3) Property imported from a foreign country for which an executive order is in effect (4) Any tangible property used predominantly outside the United States during the year. On the flipside, if a farmer's property qualifies for GDS, but the farmer would rather use ADS, the election must be for all property in the same property class. Additionally, once the election is made, it is not possible to revoke the election.

In order to find the recovery period of property, Table 1 lists common farming assets and the recovery periods under both system. As can be seen from this list, property classes could be 3, 5, 7, 10, 15, 20, or 25 years, or even residential property or nonresidential property. Some of the most common property would include agricultural structures, 10 years under GDS and 15 years under ADS, cattle, 5 years under GDs and 6 years under ADS, farm machinery and equipment, 7 years under GDS and 10 years under ADS, and heavy duty trucks weighing 13,000 libs or more, 5 years under GDS and 6 years under ADS.

In addition to figuring out which property class a farmer's property falls into, a farmer must also either choose or figure out which convention his or her property will fall into. The type of convention used will determine the number of months a farmer is able to claim depreciation both in the year the property is placed in service as well as the year the property is disposed of.

The three common conventions under MACRS are the half-year, mid-month, and mid-quarter conventions. Further details on depreciation methods can be found in the IRS Publication 946.

Under the GDS depreciation system, there are three differing depreciation methods, 200% double declining balance, 150% double declining balance, and the straight line method, but under ADS there is only one depreciation method, straight line method. Table 2 details which types of property are supposed to use which types of depreciation methods. For example, property used in farming would fall under the 150% declining balance method under GDS. It is possible to elect to use an alternative method, as long as the election is made before the due date of the tax return (Internal Revenue Service, Publication 225).

In order to help figure out the depreciation, the IRS has published Tables 3 and 4 to make calculating the depreciation percentages easier. The percentages in the tables should be multiplied by the unadjusted basis of the property. Generally, once a specific method is chosen, that method should be used for the entire life of the property. If the depreciation allowed or an addition or improvement is made to the property, which, in turn, is depreciated as a separate property, the depreciation method should be stopped and reassessed (Internal Revenue Service, Publication 946).

Amortization of Business Start-up Costs

As defined by the IRS amortization is "a method of recovering certain capital costs over a fixed period of time." Start-up costs for farmers can be amortized for tax purposes. Business start-up costs can be amortized for 180 months, which starts with the month that the business actually begins. Amortization works just like straight-line depreciation, so the costs will simply be divided by 180 months, with the resulting amount amortized each month, until the final month (Internal Revenue Service, Publication 225).

Self-Employment Tax

Most farmers are self-employed, which means that they do not have an employer deducting the normal Medicare and social security taxes from their paycheck. In order for farmers to be eligible for future Medicare and social security benefits upon retirement, farmers must pay self-employment tax each year on their tax return. Self-employment tax should be calculated and included on Schedule SE on Form 1040. For 2012, the self-employment tax rate is 13.3%, which includes 10.4% for social security and 2.9% for Medicare. In order to receive full benefits, a farmer must earn credits each year, with the most possible being four each year. In order to receive one credit, $1,130 of earnings must be earned each quarter, for a total of $4,520. Since the income of farmers can vary throughout the year, the government allows for the $4,520 to be earned any time throughout the year, whether it is in one quarter or spread over four quarters (Internal Revenue Service, Publication 225).

Forms Commonly Used in Farming Taxation

The following is a list of some of the common tax forms association with farming taxation:

535 – Business Expenses

1099 – PATR – Taxable Distributions Received from Cooperatives

4562 – Depreciation and Amortization

4797 – Sales of Business Property

4835 – Farm Rental Income and Expenses

6251 – Alternative Minimum Tax – Individuals

8903 – Domestic Production Activities Deduction

Schedule A – Itemized Standard Deduction

Schedule E – Supplemental Income and Loss

Schedule F – Profit or Loss from Farming

Schedule J – Income Averaging for Farmers and Fisherman

Conclusion

There are many specific issues related to farm taxation. However, once a system is set in place for a farm, only small adjustments should need to be made. Although there are many qualifiers to farming taxation rules, as long as the qualifiers and details are taken into accounting, farming taxation is not as difficult as it may seem. More information, especially concerning larger farms, on taxation or farming taxation can be found on the IRS website.

Appendices (IRS Publication 225)

Table 1 – Farm Property Recovery Periods

Assets	Recovery Period in Years GDS	ADS
Agricultural structures (single purpose)	10	15
Automobiles	5	5
Calculators and copiers	5	6
Cattle (dairy or breeding)	5	7
Communication equipment[1]	7	10
Computer and peripheral equipment	5	5
Drainage facilities	15	20
Farm buildings[2]	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Goats and sheep (breeding)	5	5
Grain bin	7	10
Hogs (breeding)	3	3
Horses (age when placed in service)		
Breeding and working (12 years or less)	7	10
Breeding and working (more than 12 years)	3	10
Racing horses	3	12
Horticultural structures (single purpose)	10	15
Logging machinery and equipment[3]	5	6
Nonresidential real property	39[4]	40
Office furniture, fixtures, and equipment (not calculators, copiers, or typewriters)	7	10
Paved lots	15	20
Residential rental property	27.5	40
Tractor units (over-the-road)	3	4
Trees or vines bearing fruit or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 lbs. or more)	5	6
Truck (actual weight less than 13,000 lbs)	5	5
Water wells	15	20

[1] Not including communication equipment listed in other classes.
[2] Not including single purpose agricultural or horticultural structures.
[3] Used by logging and sawmill operators for cutting of timber.
[4] For property placed in service after May 12, 1993; for property placed in service before May 13, 1993, the recovery period is 31.5 years.

Table 2 – Deciding Which Depreciation Method to Use

System/Method	Type of Property
GDS using 150% DB	• All property used in a farming business (except real property) • All 15- and 20-year property • Nonfarm 3-, 5-, 7-, and 10-year property[1]
GDS using SL	• Nonresidential real property • Residential rental property • Trees or vines bearing fruit or nuts • All 3-, 5-, 7-, 10-, 15-, and 20-year property[1]
ADS using SL	• Property used predominantly outside the United States • Farm property used when an election not to apply the uniform capitalization rules is in effect • Tax-exempt property • Tax-exempt bond-financed property • Imported property[2] • Any property for which you elect to use this method[1]
GDS using 200% DB	• *Nonfarm* 3-, 5-, 7-, and 10-year property

[1]Elective method
[2]See section 168(g)(6) of the Internal Revenue Code

Table 3 – 150% Declining Balance Method (Half-Year Convention)

Year	3-Year	5-Year	7-Year	20-Year
1	25.0%	15.00%	10.71%	3.750%
2	37.5	25.50	19.13	7.219
3	25.0	17.85	15.03	6.677
4	12.5	16.66	12.25	6.177
5		16.66	12.25	5.713
6		8.33	12.25	5.285
7			12.25	4.888
8			6.13	4.522

Table 4 – Straight Line Method (Half-Year Convention)

Year	3-Year	5-Year	7-Year	20-Year
1	16.67%	10%	7.14%	2.5%
2	33.33	20	14.29	5.0
3	33.33	20	14.29	5.0
4	16.67	20	14.28	5.0
5		20	14.29	5.0
6		10	14.28	5.0
7			14.29	5.0
8			7.14	5.0

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